



Michael C. Schlachter, CFA
Managing Director

May 25, 2007

Dr. Russell Read
Chief Investment Officer
California Public Employees' Retirement System
400 P Street, Suite 3492
Sacramento, CA 95814

Re: New Incentive Compensation Proposal

Dear Russell,

You requested Wilshire's opinion regarding your proposal to modify the calculation methodology for the incentive compensation structure for the total fund and for the major asset classes. As you are aware, Wilshire has worked closely with Staff over the last month in developing these new compensation algorithms, and we believe that the concept as proposed incorporates most of our comments and input.

Although the conceptual proposal awaits input from the Investment Committee, we agree with the concept of expanding the measurement of total fund success or failure (in the context of incentive compensation) from the single benchmark comparison of the past to this new multi-faceted approach. We believe:

- The addition of a comparison to peer performance adds the element of measuring whether CalPERS' size and internal management add or detract value relative to other large pension plans.
- Measurement versus a CPI-based benchmark determines whether CalPERS is gaining or losing ground relative to its spending commitments over time, and is an extremely valuable metric to the people of California, who eventually will be expected to make up any funding shortfall.
- The use of an information ratio-based element will help to ensure that CalPERS' Staff continues to pursue the most risk-efficient investment structure possible, and not simply chase high returns in the hopes of maximizing the other measures.

We also agree with (and actually proposed) the idea of having half of the total fund element of compensation derive from performance versus an index, since this has been the historical measurement of success and is still the bottom-line most important element of determining CalPERS' investment success, including such elements as whether active management adds or detracts value relative to a passive approach, or whether internal management is superior to external management of assets.

We also agree with the simplification of the calculation process, from the current 0.0-1.0-1.5 system to the new system of 0.0 to 1.0, since this will be easier to calculate and for the public to understand. It will also have the benefit of raising the level of performance necessary to reach the “normal” bonus that would have been earned under the old system, since an investment officer will now need to perform in the top third of the range to earn the same bonus as would have been earned at the 1.0 midpoint level under the old system. Across the board, this will more closely align Staff incentive compensation with the goal of adding value to the investment portfolio above a passive benchmark.

As a test of the proposed structure, Wilshire backtested the total fund component of the 2005-2006 fiscal year incentive compensation. Due to the total fund’s performance relative to its benchmark over the preceding one-, three- and five-year periods, the total fund component was maxed out under the old system. Using the proposed methodology, the total fund component would fall slightly (due largely to the CPI+ factor over the five year time period) – a decrease of about 5%. Note that this is only on the bonus attributable to the total fund’s performance. This represents a fraction of the total incentive compensation package. Using the percentage linked to total fund performance for FY 2006-2007, this would represent less than a 2% decrease overall for the CIO, a 1.3% decrease overall for the asset class Senior Investment Officers, and a 0.5% decrease for the Senior Portfolio Managers.

For the compensation based on performance of specific asset classes, we agree with the new and slightly higher effective “hurdle” ranges for incentive compensation, as these will reward Staff more for index-or-better performance than was the case under the old system. We also agree with the increase in the fraction of incentive compensation derived from the Total Fund as this will serve to help Staff think more globally about all of CalPERS and will decrease their focus from being solely on any single asset classes.

We look forward to continuing to discuss these incentive compensation plans with you, and to ironing out the fine details in exactly how they will be implemented. If you have any additional questions, please do not hesitate to contact me.

Sincerely,

A handwritten signature in black ink, appearing to read "Russell Read", with a stylized flourish at the end.